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THEORY AND PRACTICE

Current Studies and Concepts

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The Committee on Auditing Procedure of the American Institute of Certified Public Accountants has issued Statement on Auditing Procedure No. 41 — Subsequent Discovery of Facts Existing at the Date of the Auditor's Report. This Statement was adopted unanimously by the 24 members of the Committee, which is the senior technical committee of the Institute designated to issue pronouncements on auditing matters. Issuance of the Statement was prompted by legal actions against certified public accountants involving its subject matter.

Purpose of Statement

As indicated in the Statement, its purpose is to establish procedures to be followed by the auditor who, subsequent to the date of the auditor's report upon audited financial statements, becomes aware that facts may have existed at that date which might have affected the report had the auditor then been aware of such facts. Previous pronouncements of the Committee do not deal with this subject.

The Statement indicates that its issuance is not intended to suggest that, after an auditor has issued a report, the auditor has any obligation (excluding the auditor's obligation with respect to audited financial statements included in registration statements filed under the Securities Act of 1933) to make any further or continuing inquiry or to perform any other auditing procedures with respect to the audited financial statements covered by that report, unless new information which may affect the auditor's report comes to the auditor's attention.

Further, the Statement does not apply to situations arising from developments or events occurring after the date of the auditor's report; neither does it apply to situations where, after issuance of the auditor's report, final determinations or resolutions are made of contingencies or other matters which had been disclosed in the financial statements or which had resulted in a qualification in the auditor's report. The Statement establishes procedures which go beyond current practice; it is not intended to be retroactive.

Content of Statement

General

The Statement concludes that the auditor would be well advised to consult with an attorney when the auditor encounters the circumstances to which the Statement may apply because of legal implications which may be involved in actions contemplated by the Statement, including, for example, the possible effect of state statutes regarding confidentiality of auditor-client communications.

It states that when an auditor becomes aware of information which relates to financial statements previously reported on by the auditor, but which was unknown to the auditor at the date of the auditor's report, and which is of such a nature and from such a source that the auditor would have investigated it had it come to the auditor's attention during the course of the audit, the auditor should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of the auditor's report. It provides that the auditor should discuss the matter with the client at whatever management levels the auditor deems appropriate, including the Board of Directors, and request cooperation in whatever investigation may be necessary.

The Statement lists specific procedures to be followed by an auditor after the auditor concludes as a result of investigation that the audit report would have been affected if the information had been known to the auditor at the date of the audit report and had not been reflected in the financial statements, and the auditor believes there are persons currently relying, or likely to rely, on the financial statements who would attach importance to the information. With respect to the latter, the Statement indicates that consideration should be given, among other things, to the time elapsed since the financial statements were issued.

Procedures to be Followed

The Statement says that the auditor should advise the client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying, or who are likely to rely, on the financial statements and the related auditor's report. Depending upon the circumstances, such procedures would be as follows:

1. If the effect on the financial statements or auditor's report of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and auditor's report. The Statement provides that the reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report and that, generally, only the most recently issued audited financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.
2. If issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent, so that disclosure is not delayed, disclosure of the revision can be made in such statements instead of reissuing the earlier statements.
3. If the effect on the financial statements of the subsequently discovered information cannot be determined without a prolonged investigation and the issuance of revised financial statements and auditor's report would necessarily be delayed and it appears that the information will require a revision of the statements, appropriate disclosure would consist of notification by the client to persons who are known to be relying, or who are likely to rely, on the financial statements and the related report that they should not be relied upon, and that revised financial statements and auditor's report will be issued upon completion of an investigation. If applicable, the client should be advised to discuss with the Securities and Exchange Commission, stock exchanges, and appropriate regulatory agencies the disclosure to be made or other measures to be taken in the circumstances.

The Statement provides that the auditor should take whatever steps the auditor deems necessary to obtain satisfaction that the client has made the necessary disclosures.

It states that if the client refuses to make the above-described disclosures the auditor should notify each member of the Board of Directors of such refusal and of the fact that, in the absence of disclosure by the client, the auditor will take steps to prevent future reliance upon the auditor's report. The Statement notes that the steps that can appropriately be taken will depend upon the degree of certainty of the auditor's knowledge that there are persons—persons who would attach importance to the information—who are currently relying, or who will rely, on the financial statements and the auditor's report and upon the auditor's ability as a practical matter to communicate with them.

The Statement provides that, unless the auditor's attorney recommends a different course of action, the auditor should take the following steps to the extent applicable:

1. Notification to the client that the auditor's report must no longer be associated with the financial statements.
2. Notification to regulatory agencies having jurisdiction over the client that the auditor's report should no longer be relied upon.
3. Notification to each person known to the auditor to be relying on the financial statements that the auditor's report should no longer be relied upon.

The Statement indicates that, when it is impracticable for the auditor to give appropriate individual notification to stockholders or investors at large, notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the auditor to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure. The Securities and Exchange Commission and the stock exchanges are considered to be appropriate agencies for this purpose as to corporations within their jurisdictions. The Statement provides guidelines as to the content of any disclosure to be made by the auditor when the client refuses to make disclosure.

Applicability

The concepts embodied in the Statement are not limited solely to corporations but apply in all cases where financial statements have been examined and reported on by independent auditors.

Progress is seldom the result of continued travel over familiar roads.

Charles M. Ewell, Jr., TRUSTEE,
January 1969